Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Cedillo	Analyst:	Darrine Distefano	Bill Number:	SB 224
Related Bills:	See Legislative History	Telephone:	845-6458	Introduced Date:	February 13, 2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Earned Income Refundable Credit

SUMMARY

This bill would allow a refundable Earned Income Credit (EIC) equal to 15% of the federal EIC.

PURPOSE OF THE BILL

It appears that the purpose of this bill is to provide a credit to low-income taxpayers.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and would apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

Summary of Suggested Amendments

Technical amendments are provided.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows eligible individuals a refundable EIC. A refundable credit allows for the excess of the credit over the taxpayer's tax liability to be refunded to the taxpayer. The credit is a percentage of the taxpayer's earned income and is phased out as income increases. The percentage varies, based on whether the taxpayer has qualifying children.

Board Position:			Department Director	Date
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The federal credit for the 2002 taxable year is determined as follows:

Eligible Individual with	Earned Income	Completely Phased-Out @	Credit Rate (%)	Maximum Credit (for all file statuses)	Maximum Proposed State Credit
1 qualifying child	$6,330	$29,201	34%	$2,506	$375.90
2 or more qualifying children	$8,890	$33,178	40%	$4,140	$621.00
no qualifying children	$4,220	$11,060	7.65%	$376	$56.40

Taxpayers cannot claim the federal EIC if their 2002 investment income (such as interest and dividends) is more than $2,550. The amount of the federal EIC is reduced by the alternative minimum tax (AMT), if any.

Existing federal law specifies that if the federal EIC was denied and the Internal Revenue Service (IRS) determined that the taxpayer's error was due to reckless or intentional disregard of the federal EIC rules, the EIC will not be allowed for the next two years. If the error was due to fraud, then the EIC will not be allowed for the next ten years.

Existing federal law allows an eligible individual to receive advance payment of the EIC by providing his or her employer with a Form W-5. Taxpayers who receive advance payments of the EIC must file an income tax return. Any advanced payments that exceed the allowable EIC are recaptured. While EIC recipients may pay little or no income tax, allowing the EIC to be received through advance payments offsets social security and other payroll taxes.

Under provisions of federal law (Title IV of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193)), certain aliens are ineligible for federal, state, and local public benefits, including the EIC. IRS implementation of Title IV is limited to verifying eligibility on the basis of Social Security numbers. The IRS delays all returns claiming the federal EIC that do not pass an automated Social Security number verification process. By its terms, this federal law applies to states.

Existing state law does not provide an EIC.

Existing state law provides various credits to taxpayers that may reduce their state income tax below tentative minimum tax (TMT). Generally credits cannot reduce a taxpayer's regular tax below TMT for purposes of the AMT calculation. AMT liability ensures that taxpayers with substantial economic income and credits, deductions, and other preference items do not completely escape taxation.

Under state law**,** individuals who make less income than the filing thresholds are not required to file an income tax return since the standard deduction and personal exemption credit would eliminate any tax liability. For 2002, these filing thresholds are $12,080 in gross income or $9,664 in adjusted gross income (AGI) for single taxpayers and $24,160 in gross income or $19,328 in AGI for married filing joint taxpayers. These thresholds are increased based on the number of dependents. These thresholds also are increased annually for inflation.

THIS BILL

This bill would provide a refundable state EIC equal to 15% of the EIC (prior to its reduction by AMT) allowed by federal law. The amount of state EIC would be reduced by state AMT, if any. Any state credit in excess of the state tax liability would be credited against other amounts due, and the balance would be refunded to the taxpayer.

This bill specifies the proposed EIC would be refunded to the taxpayer only if funds are appropriated for that purpose by the Legislature.

This bill would require the Franchise Tax Board (FTB) to train and inform employers how employees would make withholding adjustments to reflect the credit.

This bill specifies that the federal allowance of advanced payment of EIC provided through additional employer payments shall not apply. However, the bill would allow for the adjustment of withholding to reflect the credit.

This bill would include the refundable EIC in the list of credits that can reduce regular tax below TMT for purposes of AMT.

This bill also would add the refundable EIC to the Revenue and Taxation Code (R&TC) provisions specifying when interest starts to accrue on overpayments.

This bill would provide that any refunds of the credit would be treated the same as the federal EIC in determining if an individual qualifies for benefits under Division 9 of the Welfare and Institutions Code. The federal EIC is not considered in determining if an individual qualifies for welfare. This provision does not impact the department and will not be included in this analysis.

IMPLEMENTATION CONSIDERATIONS

This bill would require an appropriation of money by the Legislature to pay for this credit. Refunds of the credit to some taxpayers could be delayed if the amount of credits claimed exceeds the funds appropriated. Prior to approval of a continuous appropriation, refunds of the refundable renters' credit were delayed and interest had to be paid to taxpayers until more funds were appropriated to cover claims in excess of the initial appropriation. If funds are not available to cover refunds due, this would result in payments of interest to refund recipients and in departmental costs associated with additional calls to the service center inquiring about delayed refunds.

Many taxpayers eligible for the federal EIC probably have little or no federal or state tax liability and do not have a California filing requirement. Some 600,000 current nonfilers would be required to file tax returns to claim the proposed EIC, which would significantly impact the department's programs and costs.

Low-income taxpayers would claim the proposed credit under this bill. Low-income taxpayers generally file their tax returns on Forms 540A or 540-2EZ. To add the EIC, several lines must be added to Forms 540, 540A, and 540NR. The Form 540-2EZ cannot accommodate additional lines because of the reduced size of the form; therefore, taxpayers currently filing on the Form 540-2EZ would be required to file a Form 540A to claim the proposed EIC. Changes to these tax forms would result in a significant impact on the department's operations and costs.

The IRS completes tax returns for some taxpayers who claim the refundable EIC. The IRS also adjusts many returns due to taxpayer errors and fraud concerns. Consequently, the correct federal EIC amount may not be known until after the taxpayer has filed the state return and claimed the proposed California credit. FTB does not have access to the federal AGI figures that are used for the federal EIC calculation; therefore, FTB would need to acquire a taxpayer's federal AGI information, issue an assessment to retrieve incorrect refunds, and store additional documentation on these taxpayers. This would result in additional departmental costs.

This bill would require FTB to provide training and information directly to employers; however, the Employment Development Department (EDD), rather than FTB, advises employers on matters relating to withholding. If such information could be provided indirectly through FTB's normal methods for providing information to tax preparers and taxpayers (i.e., instructions with tax forms, the Tax News newsletter) or through EDD advisories, this provision would not cause significant implementation issues. If this department were required to contact all employers in the state, significant resources would be required to implement this provision. Clarification is needed before the department could implement this portion of the bill.

Under specific provisions of federal law, denial of the EIC is treated as a deficiency, subject to protest and appeal. The bill does not specify protest and appeal rights in connection with denial of the proposed California EIC. It is unclear when denial of the state EIC would be subject to protest and appeal rights under state law.

It is unclear if taxpayers would be ineligible for the state credit because of reckless or intentional disregard of the rules or because of fraud in claiming the state credit as provided under federal law.

This bill would allow a credit that is not in whole dollar amounts. It would be cost effective to round the state credit amount to the nearest whole dollar.

TECHNICAL CONSIDERATIONS

The Economic Growth and Tax Relief Act of 2001(P.L. 107-16) made several changes to the EIC, such as simplifying the definition of earned income, simplifying the calculation of the EIC by using AGI, eliminating the reduction of EIC for taxpayers subject to AMT, adding a foster child to the relationship test, changing the tie-breaker rule for a qualified child, and various other changes. The attached Amendment 1 is provided to replace the incorrect reference to the public law. Amendment 1A corrects the reference to AMT.

Also, the attached Amendments 2 & 3 is provided to remove an obsolete reference to the refundable renter's credit.

LEGISLATIVE HISTORY

AB 1854 (Cedillo, 1999/2000) and SB 1421 (Solis, 1999/2000) were identical to this bill. AB 1854 did not pass out of the Assembly Appropriations Committee. SB 1421 did not pass out of the Senate Revenue & Taxation Committee.

AB 2466 (Wiggins, 1999/2000) would have provided a nonrefundable Earned Income Credit (EIC) in an amount equal to an unspecified percentage of the earned income credit allowed by federal law. This bill remained in the Assembly Revenue & Taxation Committee.

PROGRAM BACKGROUND

Prior to its sunset in 1992, California law provided a nonrefundable low-income tax credit of an amount ranging from 20% to 100% of the "computational tax," as defined, based on the taxpayer's AGI. The AGI amounts were indexed annually by the FTB. The "computational tax" was defined as the regular tax less all nonrefundable tax credits. This low-income tax credit could only be taken after all other allowable credits, except refundable credits.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida only has a corporation income tax; therefore, this personal income tax credit is not applicable.

Illinois allows taxpayers to claim a nonrefundable credit equal to 5% of their federal EIC on their return.

Massachusetts allows taxpayers to claim a refundable credit equal to 15% of their federal EIC. If the taxpayer has requested the IRS to calculate the federal EIC and the IRS has not notified them by April 15th, Massachusetts allows the taxpayer to file a six-month extension.

Michigan does not offer its taxpayers an EIC.

Minnesota allows taxpayers to claim a Working Family Credit (WFC) if they also claimed the federal EIC. The WFC is based on either the federal earned income or the federal AGI depending on whichever amount is smaller.

New York allows taxpayers to claim a refundable credit equal to 27 1/2% (.275) of the federal EIC on their return.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved, but are anticipated to be significant. If the bill continues to move through the legislative process, departmental costs will be identified and an appropriation will be requested.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

This bill would result in revenue losses as follows:

Estimated Revenue Impact of SB 224 As Introduced February 13, 2003 Effective for tax years 1/1/2003 Enacted after 6/30/2003 $ Millions			
2003-04	2004-05	2005-06	2006-07
-$640	-$660	-$675	-$690

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this credit would depend on the amount of California taxpayers claiming a federal EIC. This amount, in turn, depends on the amount of earned income and AGI claimed by low-income California taxpayers, and whether the taxpayer currently files a tax return or not. It is assumed that almost all taxpayers who avail themselves of the federal credit would also avail themselves of the state credit.

The starting point for this estimate is the amount of federal EIC claimed by California taxpayers in the 2000 tax year, approximately $3,800 million. This amount is grown by 5.4% to account for the change in the AGI phase-out range since 2000. This amount is further grown by 2% to reflect the 2001 federal law changes to the EIC. The law-adjusted amount in tax year 2000 is $4,060 million. This number is then grown from the 2000 level to the 2001 level by the growth in returns with AGI's of less than $50,000, 0.3%. From 2001 to 2007, the number is grown by 2.5% per year to reflect overall return growth projections.

The amount of the federal EIC for 2003 is estimated to be $4,300 million. For each tax year, the estimated federal EIC amount is multiplied by 15%, the proposed state credit rate, to arrive at the total state impact for that year. The estimated revenue impact for 2003 is $640 million.

POLICY CONCERNS

The IRS has experienced a significant number of invalid and fraudulent returns in connection with the refundable federal EIC. According to a study conducted by the IRS "Compliance Estimates for the Earned Income Credit Claimed on 1999 Returns," of the $31.3 billion claimed in federal EIC, it is estimated that between $8.5 and $9.9 billion were invalid or fraudulent claims. However, the federal changes to the EIC are expected to improve compliance rates and reduce the number of invalid claims.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 224
As Introduced February 13, 2003

AMENDMENT 1

On page 6, line 30, strikeout "106-107" and insert "107-16"

AMENDMENT 1A

On page 6, revise lines 20-22 to read as follows:

the Internal Revenue Code.

AMENDMENT 2

On page 7, line 19, strikeout "or" and on line 20, strikeout "subdivision (j) of Section 17053.5"

AMENDMENT 3

On page 7, line 35, strikeout "or subdivision (j) of Section 17053.5"